

# Reflections on the Strategy of Monetary Policy

*Remarks by Robert P. Black, President, Federal Reserve Bank of Richmond,  
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## Introduction

It's a particular pleasure to be with you this morning at your annual convention. I want to focus my comments today on monetary policy. This seems like a natural subject for a Federal Reserve Bank official to address. Some of you may be disappointed by my choice, however, since there are a number of other topics I could tackle that might strike you as more pressing such as the current concern about a possible credit crunch, progress toward the resolution of the problems in the thrift industry, deposit insurance, or prospective changes in our banking and financial structure. We at the Federal Reserve are naturally interested in all these matters. Our most important responsibility at the Fed, however, is to manage the nation's monetary system and, in particular, the rate of growth in the supply of money. Moreover, by discharging this fundamental responsibility effectively we may well be able to facilitate resolution of the seemingly more immediate issues I just mentioned as well as others. In fact, it can be argued that some of our more immediate problems, such as the thrift crisis, may have been brought on in part by past monetary policies that in retrospect were less than optimal.

## A More Useful Conception of Monetary "Policy"

The first thing I want to stress is the time frame I have in mind when I talk about monetary "policy." When many, and perhaps most people, think of the Fed and monetary policy, they focus almost automatically on interest rates and where they are headed and how our actions may affect them in the near future. Since the day-to-day operating lever we use in conducting monetary policy is the federal funds rate, many people equate changes in the funds rate with changes in monetary policy. For example, the press typically refers to an increase in the rate as a "tightening" of monetary policy.

This is definitely not what I have in mind when I think of monetary policy, and I shall argue later in my remarks that equating changes in the funds rate and other money market indicators with changes in

monetary policy has been a particularly misleading practice and has contributed to many of the problems we have experienced over the last 30 years. Instead, when I speak of monetary policy, I am talking about both the longer-run objective the Federal Reserve is trying to achieve in the economy through its monetary actions *and* the timetable and set of procedures for attaining that objective.

To understand the distinction I am making, consider the setting of the prime rate by your bank. Obviously, the "policy" of your bank is not simply to set the prime rate at a certain level. Your policy embraces your larger goal of achieving a certain rate of return on assets or equity over a particular time horizon. To help in reaching this goal, you maintain the prime rate at a certain spread above your cost of funds. Clearly, changes in the prime are just part of a larger set of procedures designed to achieve the ultimate goal of a target return on assets or equity. Similarly, changes in the funds rate have to be considered in the context of the larger strategy of monetary policy.

## A Brief Historical Review

The principal questions I want to address this morning are (1) what is an appropriate monetary policy for the Federal Reserve and (2) how far have we come in developing such a policy? I shall begin with a brief review of the major monetary developments over the last 30 years and, on the basis of this review, make some general observations about how policy has worked over this period and how it has affected inflation and the economy. With these generalizations in mind, I shall then summarize my view of an appropriate monetary policy in the sense in which I have just defined the term and conclude with an assessment of the progress we have made in putting such a policy in place.

My historical review necessarily will be very brief and oversimplified, but even a quick review suggests some strong generalizations about an appropriate monetary policy. Think back if you will to the late 1960s when large increases in federal spending on social programs and defense put strong upward

pressure on interest rates. In this period the Fed was sometimes slow to let the funds rate and other short-term interest rates rise enough to reflect these pressures. Consequently, money growth accelerated, which resulted in a sharp increase in the rate of inflation. The System eventually responded to the higher inflation by pushing the funds rate up over three percentage points in 1969, and the recession of 1970 followed.

Roughly this same sequence was repeated two more times in the 1970s. In 1972, an expanding economy put upward pressure on interest rates. The Fed allowed the funds rate to adjust upward modestly before the end of the year, but in retrospect the increase was not enough to prevent money growth and inflation from rising strongly. The System responded to the accelerating rate of inflation by raising the funds rate five percentage points in 1973, and the economy again fell into a recession. Of course, the rise in oil prices during this period undoubtedly affected both the inflation rate and the general economy, but it seems clear with the benefit of hindsight that our failure to let short-term interest rates rise more freely in 1972 was also a factor since it made a much sharper increase unavoidable the following year.

The third episode, and one I'm sure you all remember quite well, occurred in the late 1970s. In this period rapid economic growth again put upward pressure on interest rates, yet the funds rate remained essentially constant from late 1975 through mid-1977. Throughout this period, of course, the System was justifiably concerned about the lingering effects of the huge increases in oil prices in 1973 and 1974, and we naturally wanted to do whatever we could with monetary policy to help minimize the damage these increases might inflict on the economy. Even so, looking back it seems evident that our reluctance to let the funds rate adjust upward for such an extended period helped set the stage for the sharp acceleration in both the rate of growth of the money supply and inflation that followed. We began to raise the funds rate in late 1977 and continued to raise it through 1978, but our actions came too late and were too restrained. Money growth remained high and inflation continued to accelerate. Ultimately, in a crisis atmosphere, the funds rate moved up by about eight percentage points in late 1979 and early 1980, and the relatively mild recession of 1980 ensued. This was followed by a brief recovery and then by the much deeper and more protracted recession of 1981-1982, which was very costly in terms of lost

jobs and output. About the only good thing one can say about the performance of the economy in the early 1980s is that the rate of inflation was cut roughly in half. The rate remained in a range of 3 to 5 percent throughout the remainder of the 1980s.

These developments in the late 1960s and 1970s highlighted the link between excessive money growth and inflation and led to a number of changes in our procedures that involved setting more explicit goals for the growth of the money supply and working to control this growth more closely in order to achieve these goals. In 1970 the FOMC first began to set explicit short-run targets for money growth, and as the decade progressed the use of the money supply as a target became more firmly institutionalized. In 1975, in response to a congressional resolution, we began to announce quarterly targets for the growth rates of several so-called monetary aggregates—the various “M’s” with which you are all familiar. The Humphrey-Hawkins Act of 1978 improved our procedures by requiring us to set money growth targets on a calendar-year basis. Earlier we had set four-quarter-ahead targets each quarter, so that by the time we reached the end of a target period we were already working on a new target with a new time frame.

These steps were all in the right direction, but even after Humphrey-Hawkins was passed there was still a flaw in the targeting procedure, which is usually referred to as the “base drift” problem. Base drift arises under our procedure because the base for the target set each year is the *actual* level of the monetary aggregate in the preceding period rather than the *target* level in that period. Consequently, any target miss in the preceding period is forgiven when a new target is set, and the base for the new target “drifts” either upward or downward. Consequently, the longer-term growth rate of money over a period of several years can be well above any of the individual annual target rates if the actual growth rates persistently exceeded the target rates. This is exactly what happened in the late 1970s. The upward base drift in this period, along with our tendency to raise the funds rate rather gradually when money growth first accelerated in 1977 and 1978, were major factors contributing to the subsequent double-digit inflation.

### Some General Observations About Past Policy

This brief review of events over the last three decades points to several generalizations which have influenced my thinking on what constitutes an appropriate monetary policy. The first and most

obvious point is that the level of the federal funds rate and the direction of changes in the funds rate are not reliable indicators of monetary policy. A particular level of the rate could be consistent with a relatively restrictive stance or a relatively easy stance depending on what else is happening in the economy and the financial markets. The funds rate increased in 1968, in 1972, and in 1977 and 1978. Yet in retrospect it is clear that policy in each of these periods was not too tight but too easy. Consequently, money growth accelerated.

We also know from our experiences over this period—if we did not know it before—that rapid money growth inevitably leads to an acceleration of inflation. Just as inevitably, pressures eventually mount both inside and outside the Fed to take aggressive action to bring this inflation under control. In each of the three episodes I reviewed, these actions unfortunately were followed by recessions.

Another generalization suggested by our experience over the last 30 years—and one that I believe is extremely important—is that expansionary monetary policies and high rates of inflation do *not* lead to faster economic growth. To put it in the jargon of economists, there is no trade-off between inflation and longer-run economic growth. On the contrary, persistently high rates in inflation have generally been associated with relatively low rates of real economic growth.

A fourth conclusion, which has been a major disappointment for me, is that the development of our monetary targeting procedures beginning in the early 1970s was not sufficient to prevent us from making some of the same policy errors in the late 70s we had made twice before in the preceding 15 years or so. As I suggested earlier, upward base drift in our money supply targets probably contributed to the very high trend growth in the monetary aggregates in the late 70s. And our reluctance to adjust the funds rate upward as promptly as we might have when the indications of excessive money growth and rising inflation first became available was probably also a factor. Together these two factors largely neutralized the institutional improvements we made in this period.

A final general observation suggested by our experience over the last 30 years is that despite our strong desire at the Fed throughout this period to hold inflation under control, the record unfortunately makes it clear that we were less than fully successful.

There has been a noticeable tendency, on average and in retrospect, to follow policies that have allowed the price level to creep upward. This same tendency has been apparent in many other industrial countries over the same period. No statistic better illustrates this tendency than the *fourfold* increase in the price level since 1965. Economists have devoted much effort in recent years to trying to understand the reason for this experience.

One popular explanation in the academic literature, sometimes referred to as the “time inconsistency” problem (or in layman’s terms, “changing your mind”), runs along the following lines. Suppose that a central bank commits itself to an anti-inflationary monetary policy and that this commitment is credible to the public. The bank may well have every intention of fulfilling this promise at the time it is made. (I am assuming here that the bank is not legally or constitutionally bound to fulfill its commitment.) Subsequently, however, the bank will see that the credibility of its promise gives it an opportunity to stimulate real economic activity temporarily by surprising the public with an unexpectedly expansionary policy—that is, an unexpected acceleration in the growth of the money supply. The bank may find it exceedingly difficult to resist the temptation to exploit this opportunity even if it wishes to keep inflation low. To the extent that central banks succumb to this temptation in practice, their behavior, in combination with the public’s ability to form expectations of policy actions that are correct on average, inevitably leads to inflation. The extent to which this notion applies to our own experience in the United States is not entirely clear yet, but the idea probably deserves further thought and research.

A second explanation for the apparent inflationary tendency in our policy over time is the one-sided political pressures brought to bear on policy. Government officials and others routinely exhort the Fed to follow “easier” policies, by which they mean lower short-term interest rates. These exhortations arise because many people believe (1) that the Fed can “trade off” a higher rate of inflation for more economic growth and (2) that the Fed determines the rate of interest independently of the rate of inflation and other economic conditions. As I have already suggested, both these beliefs strike me as misguided. A particularly damaging misperception among some government leaders is the one I mentioned at the beginning of my remarks: namely, that a rise in the federal funds rate represents a “tighter” monetary policy. As the experience of the 1960s and 1970s

illustrated time and time again, this misperception has frequently led observers to conclude that the Fed is following an excessively "tight" policy when in fact the reverse has been true.

Let me state and then underline my conviction that the FOMC has never *consciously* made decisions on the basis of political considerations. Political pressures are always present, however, and it seems possible that at times these pressures may have had some effect on policy at the margin. In any case, the key point is not why monetary policy has had an inflationary tendency over the last three decades, but that in fact it has had this tendency, and I think it would be hard for anyone to dispute this point.

### Suggestions for Improving Monetary Policy

In view of our experience over the last three decades, what can we do to improve monetary policy in the longer-run, strategic context I discussed at the beginning of my comments? As I see it, the most important lessons from our experience over this period are that price stability should be the primary objective of monetary policy and that a specific timetable should be set for achieving it. As many of you know, Congressman Stephen Neal, Chairman of the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs, has introduced a Resolution that would instruct the Fed to make price stability its overriding goal and direct the Fed to achieve this goal within five years. I recently testified in favor of this Resolution, as did Chairman Greenspan and three other Federal Reserve Bank presidents.

A further lesson from our experience is that our procedures for controlling the growth of the money supply need to be improved. My own view is that setting targets for money growth that cover periods not of just one year but several years would help us greatly in our efforts to achieve longer-run price stability. Obviously, we must then hit the targets consistently. Persistent overshoots of the annual targets must not be allowed to cumulate as happened in the late 1970s. A big step forward in this regard is the recent development of a statistical model by the staff of the Board of Governors that provides an early warning to the FOMC as to whether its policies are working to increase longer-run inflationary pressures or decrease them. This is the so-called "P\* model" that you've probably seen discussed in the financial press. In my judgment, a multi-year procedure for setting money supply targets guided by something like the P\* model would provide a reliable

and powerful strategic framework for moving toward full price stability.

A final lesson suggested by our experience is that if we want to hit our monetary targets and achieve price stability, we will have to be prepared to adjust the federal funds rate (or whatever other operating instrument we may be using) promptly at the first signs of excessive money growth and incipient inflation. I call this willingness to move the funds rate up promptly "erring on the side of restrictiveness." The 1960s and 70s suggest that the risks of policy errors are asymmetric. Increases in the funds rate can be reversed quickly if they turn out to be inappropriate. In contrast, failure to let the funds rate rise in a period when market forces are naturally putting upward pressure on interest rates can raise inflation expectations and put even greater upward pressure on rates. As this process proceeds, an ever-increasing upward adjustment in the funds rate becomes necessary to bring it in line with market forces. In this situation we risk losing control of the rate of growth in money and inflation. In short, we need to act *before* inflation gets out of hand rather than after.

### Prospects for Monetary Policy

My greatest hope is that a policy of the kind I have just outlined will be put in place soon. I am generally optimistic regarding the prospects for such an outcome, although realism requires a note of caution.

My optimism reflects positive recent developments in each of the three areas I just reviewed. *First*, there is a growing consensus within the Federal Reserve System and among members of the FOMC that price stability should be the overriding goal of monetary policy. I can say without qualification that, as a group, the current members of the FOMC and nonvoting presidents are the most dedicated inflation fighters I have seen since I have been associated with the Committee. Moreover, the view that price stability should be the primary goal of monetary policy is now shared by at least some members of Congress. The introduction of the Neal Resolution and the public discussion of its provisions represent considerable progress, even if the Resolution is not enacted in the near-term future. *Second*, while we have not changed our procedures for setting annual money supply targets, we are paying more attention to longer-run money growth and its implication for inflation. The development of the P\* model I mentioned earlier reflects this emphasis. *Finally*, I believe there is a growing recognition within the Fed that the goal of price stability requires us to adjust the

funds rate or other operating instrument more promptly *before* inflation accelerates. Twice in the 1980s—in 1984 and again in late 1988 and early 1989—we let the funds rate increase substantially even though inflation was not rising rapidly at the time. Each of these times we were criticized by some for being too “restrictive,” but I am convinced that these actions contributed to the relatively stable inflation and surprisingly persistent economic growth we have enjoyed over the last seven years.

Having said this, I have to acknowledge in all candor that my optimism regarding our ability to pursue a policy aimed at achieving true price stability is a cautious optimism at this point. It is cautious because a large part of the general public and many government leaders are still relatively unconcerned about inflation. I was shocked to read of a recent poll showing that 82 percent of the members of the National Association of Business Economists do not favor the objectives of the Neal Resolution. The majority of those surveyed apparently believe that the cost of reducing inflation below its current 4 to 5 percent trend rate would be

too great because the public has become so accustomed to inflation at about this rate. I cannot agree with this conclusion. Nothing in our experience over the last 30 years indicates that we can maintain inflation at a steady 4 to 5 percent rate indefinitely. If we accept a 4 to 5 percent rate as tolerable, I am confident it will be only a matter of time before we are faced with a much higher rate. Further, I believe that a *gradual* reduction in the rate over a relatively long but well-defined period of time could be accomplished without unacceptable costs to the economy.

In conclusion, the Federal Reserve has made considerable progress toward developing and implementing an appropriate monetary policy aimed at attaining price stability and the strong growth in production and jobs that go with it. We still have a great deal of work to do in developing public and Congressional support for this policy, however, and we obviously must succeed in this effort because without this support the policy itself will surely fail. I hope that you will support our efforts to achieve this important goal.